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March 10, 1988

Mr. Robert T. Barry, P. E.
Utilities Engineer
Bureau of Highway Design
Department of Transportation
John O. Morton Building
Concord, New Hampshire 03301

Re: Reimbursement of Income Taxes to Utility Companies

Dear Mr. Barry:

This is in response to your memoranda of February 18 and 25, 1988 concerning the State's liability for reimbursement of federal income taxes imposed on contributions in aid of construction under the Tax Reform Act of 1986. Under Section 118(b) of the Internal Revenue Code of 1986, a utility must include in its gross income as a contribution in aid of construction the amount of any cash and the fair market value of any property received in connection with the provision of services by the utility to a customer or a potential customer. It is my understanding that the Department's current Force Account Agreement for the installation of facilities for highway operation provides that the State agrees to reimburse the utility company for income taxes which may be imposed under the Tax Reform Act of 1986 on contributions in aid of construction.

As you are aware, the Internal Revenue Service has recently ruled that relocation fees received by a public utility for relocating its facilities are not to be considered taxable Contributions In Aid of Construction ("CIACs"). Internal Revenue Bulletin No. 1987-51 (December 21, 1987). Based on its analysis of the legislative history of the Tax

Reform Act of 1986, the IRS has concluded that Congress did not intend to affect the tax treatment of transfers of property to regulated utilities which are not made in connection with the provision of services and where it is clearly shown that the benefit of the public as a whole is the primary motivating factor in the transfer. Thus, it is clear that a public utility incurs no income tax liability for payments made by the State as reimbursement for the costs of relocating existing facilities.

The application of Section 118(b) becomes more problematical in the context of the Department's construction of new utility facilities to serve roadway and interchange areas, toll facilities and rest areas, and their subsequent donation to the appropriate utility. Internal Revenue Bulletin No. 1987-51 also states:

> Relocation fees are treated as CIACs and included in gross income if such payments relate to the provision of services by the utility, regardless of the status or identity of the customer from whom the fees are received ... . Since the relocation fee is a prerequisite to the provision of services to the customer, the fee is a CIAC and included in gross income even though the customer is exclusively engaged in activities for the public benefit. Similarly, payments that are made to a utility as a prerequisite to the utility providing new or additional services to particular customers are treated as CIACs and included in gross income because such payments are a prerequisite to the provision of services by the utility, although a government entity may be making the payments in question. (Emphasis added).

Internal Revenue Bulletin #1987-51, paragraph II.

The example posed by the IRS in connection with the above statement concerns a payment received by a utility relating to the relocation or extension of utility facilities to a newly constructed municipal building whose operations are conducted for the benefit of the community at large (e.g., a public hospital or civic center). It is apparent that there is room for a wide divergence in legal opinions among attorneys and the IRS concerning the applicability of Section 118(b) to the various kinds of utility-related donations made by the State.

A utility's own tax attorneys are in the best position to analyze the possible tax consequences of these transactions.

Regardless of the tax treatment eventually accorded to the various kinds of payments and contributions-in-kind made by the State in connection with its highway projects, the State of New Hampshire is not liable for any taxes assessed. The State's assumption of responsibility for reimbursing a utility for income taxes levied on CIACs may facilitate the early completion of a highway project, but it is not legally required. Accordingly, I recommend that you delete from the Department's current Supplemental Agreement concerning the installation of facilities for highway operation the provision which states:

> The State agrees to reimburse the Company for increased costs due to income taxes, or any part thereof, imposed by the Tax Reform Act of 1986 which are determined to be the State's legal liability.

Furthermore, I do not recommend that you accept the modified language which has been proposed by a utility and which you transmitted to me in your memorandum of February 25, 1988. It is the utility company and not the State of New Hampshire which is liable for any increased taxes.

I trust that the above is responsive to your questions. If you would like to discuss this matter further, please do not hesitate to contact me.

Very truly yours,

Michael J. Walls
Assistant Attorney General

MJW/k
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